No. 22,352

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

PETER PAN SEAFOODS, INC.,
a Washington corporation,
Plaintiff-Appellant

v.

UNITED STATES OF AMERICA,
Defendant

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON

BRIEF FOR THE APPELLEE

FILED

AUG 30 1968

WM. B. LUCK, CLERK

MITCHELL ROGOVIN,
Assistant Attorney General.

LEE A. JACKSON,
MEYER ROTHWACKS,
LORING W. POST,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

Of Counsel:

EUGENE G. CUSHING,
United States Attorney.

CHARLES W. BILLINGHURST,
Assistant United States Attorney.

BALLARD PRINTING AND PUBLISHING, SEATTLE, WASHINGTON — 8/28/68 — 50 COPIES

No. 22,352

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

PETER PAN SEAFOODS, INC.,
a Washington corporation,

Plaintiff-Appellant

v.

UNITED STATES OF AMERICA,

Defendant

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON

BRIEF FOR THE APPELLEE

MITCHELL ROGOVIN,
Assistant Attorney General.

LEE A. JACKSON,
MEYER ROTHWACKS,
LORING W. POST,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

Of Counsel:

EUGENE G. CUSHING,
United States Attorney.

CHARLES W. BILLINGHURST,
Assistant United States Attorney.

BALLARD PRINTING AND PUBLISHING, SEATTLE, WASHINGTON — 8/28/68 — 50 COPIES

TABLE OF CONTENTS

Page

STATEMENT OF THE ISSUES PRESENTED..2

STATEMENT OF THE CASE..................2

SUMMARY OF ARGUMENT..................8

ARGUMENT:

I. The District Court correctly held that taxpayer in substance acquired its own indebtedness at a discount in 1957 and thereby realized income in the amount of the discount under Section 61(a)(12) of the 1954 Internal Revenue Code 13

II. Section 269(a) of the 1954 Internal Revenue Code is also applicable 22

III. The taxpayer's criticisms of the District Court's decision are not well grounded 30

A. As to the Section 61(a)(12) issue.......... 30

B. As to the Section 269(a) issue.......... 37

CONCLUSION 42

APPENDIX A 44

APPENDIX B 52

CITATIONS

CASES:

American Pipe & Steel Corp., v. Commissioner, 243 F. 2d 125.... 26

Babcock v. *Phillips,* 372 F. 2d 240, certiorari denied, 387 U.S. 918.......... 32

Bazley v. *Commissioner,* 331 U.S. 737.......... 15

Bonneville Locks Towing Co. v. *United States,* 343 F. 2d 790.... 26

Bonsall v. *Commissioner,* 317 F. 2d 61.......... 41

Page

Brick Milling Co. v. *Commissioner,* decided November 13, 1963 (22 T.C.M. 1603) 38

Bush Hog Manufacturing Co. v. *Commissioner,* 42 T.C. 713.......... 29

Chase v. *Commissioner,* decided July 23, 1965 (24 T.C.M. 1054).... 36

Chisholm v. *Commissioner,* 79 F. 2d 14 32

Collins, R. P., & Co. v. *United States,* 303 F. 2d 142.......... 26

Commissioner v. *British Motor Car Distributors, Ltd.,* 278 F. 2d 392 .... 26, 29, 38, 39

Commissioner v. *Court Holding Co.,* 324 U.S. 331.......... 14, 31, 32

Commissioner v. *Montgomery,* 144 F. 2d 313.......... 37

Commissioner v. *Scatena,* 85 F. 2d 729.......... 41

Cromwell Corp. v. *Commissioner,* 43 T.C. 313.......... 40

Davant v. *Commissioner,* 366 F. 2d 874, certiorari denied, 386 U.S. 1022 .... 31, 35, 36

Eisner v. *Macomber,* 252 U.S. 189.......... 14

Factor v. *Commissioner,* 281 F. 2d 100, certiorari denied, 364 U.S. 933 32

Goldstein v. *Commissioner,* 298 F. 2d 562.......... 34

Gregory v. *Helvering,* 293 U.S. 465.......... 15, 31, 48

Griffiths v. *Commissioner,* 308 U.S. 355.......... 15, 48

Hawaiian Trust Co. v. *United States,* 291 F. 2d 761.......... 26

Helvering v. *Taylor,* 293 U.S. 507.......... 42

Higgins v. *Smith,* 308 U.S. 473.......... 15, 25, 48

Knetsch v. *United States,* 364 U.S. 361, affirming 272 F. 2d 200.... 18

Kobacker v. *Commisioner,* 37 T.C. 882.......... 36

Koppers Co. v. *Commissioner,* 2 T.C. 152.......... 35

Luke v. *Commissioner,* 351 F. 2d 568.......... 26

Maxwell Hardware Co. v. *Commissioner,* 343 F. 2d 713.......... 39

Page

Minnesota Tea Co. v. *Helvering,* 302 U.S. 609 .... 15, 31

National Carbide Corp. v. *Commissioner,* 336 U.S. 422 16

National Investors Corp. v. *Hoey,* 144 F. 2d 466 16

National Lead Co. v. *Commissioner,* 336 F. 2d 134, certoriari denied, 380 U.S. 908 33

Nutt v. *Commissioner,* 39 T.C. 231, affirmed, 351 F. 2d 452, certiorari denied, 384 U.S. 918 .... 40, 41

Patterson v. *Commissioner,* decided October 26, 1966 (25 T.C.M. 1230), affirmed *per curiam,* May 7, 1968 (68-2 U.S.T.C., par. 9471) 20

Paymer v. *Commissioner,* 150 F. 2d 334 20

Phoenix Coal Co. v. *Commisioner,* 231 F. 2d 420 14

Slocomb, J. T., Co. v. *Commissioner,* 334 F. 2d 269 26

Snyder, Thomas E., Sons Co. v. *Commissioner,* 288 F. 2d 36, certiorari denied, 368 U.S. 823 38

Southland Corp. v. *Campbell,* 358 F. 2d 333 27

Stearns Co. v. *United States,* 291 U.S. 54 37

Sun Properties v. *United States,* 220 F. 2d 171 33

Twin Oaks Co. v. *Commissioner,* 183 F. 2d 385 34

United States v. *Cumberland Pub. Serv. Co.,* 338 U.S. 451 15

United States v. *First Security Bank,* 334 F. 2d 120 18

United States v. *General Geophysical Co.,* 296 F. 2d 86, certiorari denied, 369 U.S. 849 20

United States v. *Gypsum Co.,* 333 U.S. 364 18

United States v. *Kirby Lumber Co.,* 284 U.S. 1 .... 13, 16, 28

United States v. *Lynch,* 192 F. 2d 718, certiorari denied, 343 U.S. 934 .... 14, 32

United States v. *McNair Realty Co.,* 298 F. 2d 35 18

United States v. *Phellis,* 257 U.S. 156 14

Page

United States v. *Ramos*, 393 F. 2d 618 34

Vita-Food Corp. v. *Commissioner*, 238 F. 2d 359 14

STATUTES:

Internal Revenue Code of 1939, Sec. 129
(26 U.S.C. 1952 ed., Sec. 129) 22

Internal Revenue Code of 1954:
Sec. 61 (26 U.S.C. 1964 ed., Sec. 61) 16, 21, 29, 30, 44
Sec. 269 (26 U.S.C. 1964 ed., Sec. 269) 22, 29, 38, 49, 50

MISCELLANEOUS:

H. Rep. No. 871, 78th Cong., 1st Sess., p. 49
(1944 Cum. Bull. 901, 939) 23

2 Mertens, Law of Federal Income Taxation (1967 Rev.),
Sec. 11.19 13

S. Rep. No. 627, 78th Cong., 1st Sess., p. 58
(1944 Cum. Bull. 973, 1016) 24

Treasury Regulations on Income Tax:

Sec. 1.61-12 (26 C.F.R. Sec. 1.61-12) 45

Sec. 1.269-1 (26 C.F.R. Sec. 1.269-1) 25, 46

Sec. 1.269-2 (26 C.F.R. Sec. 1.269-2) 25, 47

Sec. 1.269-3 (26 C.F.R. Sec. 1.269-3) 25, 29, 48, 51

No. 22,352

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

PETER PAN SEAFOODS, INC.,
a Washington corporation,
Plaintiff-Appellant

v.

UNITED STATES OF AMERICA,
Defendant

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON

BRIEF FOR THE APPELLEE

STATEMENT OF THE ISSUES PRESENTED

1. Whether the District Court erred in finding that mortgage notes issued by the taxpayer-corporation were in substance (as distinguished from form) purchased by the corporation at a discount and that the corporation accordingly realized taxable income, through a cancellation of indebtedness, under Section 61(a)(12) of the Internal Revenue Code of 1954 during its 1957 fiscal year (from which it follows that

the corporation is not entitled to claimed net operating loss carry-forward deductions for its 1960 and 1961 fiscal years).

2. Whether the District Court erred in holding that the net operating loss carry-forward deductions claimed by the taxpayer are also disallowable under Section 269(a) of the Internal Revenue Code of 1954 (relating to acquisitions made to evade or avoid income tax).

STATEMENT OF THE CASE

This appeal involves federal income taxes for the fiscal years ending March 31, 1960, and March 31, 1961. After the Commissioner determined deficiencies in income tax for those years in the amounts of $114,-980 and $121,737 respectively (I-R. 11-14, 43-46, 85), the taxpayer paid the deficiencies on July 7, 1964 (I-R. 85), filed claims for refund on July 16, 1964 (I-R. 10, 42), and on February 17, 1965, within the time provided in Section 6532 of the Internal Revenue Code of 1954, instituted this suit in the District Court for recovery of the alleged overpayments in taxes (I-R. 1-9). The District Court filed a memorandum decision (I-R. 109-123), which is reported at 272 F. Supp. 888. Judgment was entered on August 7, 1967, dismissing the complaint. (I-R. 128.) On October 4, 1967, within 60 days thereafter, a notice of appeal was filed. (I-R.

129.) Jurisdiction is conferred on this Court by 28 U.S.C., Section 1291.

The facts as found by the District Court (I-R. 124-127) were drawn largely from facts admitted in the pretrial order (see I-R. 111-112),[1] and may be restated as follows:

The taxpayer, now named Peter Pan Seafoods, Inc., is the successor to P. E. Harris Company, Inc. (referred to by the District Court as "New Harris" and hereinafter as the "taxpayer"), which in turn was the successor to P. E. Harris Company (hereinafter referred to as "Old Harris"), a liquidated corporation. (I-R. 124.)

The taxpayer seeks to recover income taxes and interest in the total amount of $286,886.26 which are alleged to have been erroneously assessed and collected by the Commissioner of Internal Revenue for the taxable years ended March 31, 1960, and March 31, 1961. The disputed transactions before the Court with respect to which the Commissioner determined tax deficiencies occurred during the tax year ended March 31, 1957. The deficiencies for the taxable years are caused by the recomputation of the net operating loss carry-forwards to those years as a result of the defi-

[1] For the admitted facts stated in the pretrial order, see I-R. 84-103.

ciency for the tax year ended March 31, 1957. (I-R. 125.)

On March 23, 1950, the taxpayer executed two mortgage notes in the total amount of $1,668,432 for the purchase of Old Harris, then in the process of liquidation. The notes were transferred to the Seattle First National Bank as trustee, which issued certificates of beneficial interest to the 68 former stockholders of Old Harris as beneficiaries. On December 31, 1954, the maturity date of the smaller note and interest on both notes were extended by the Seattle bank. (I-R. 125.)

During 1956, it appeared the mortgage notes of the taxpayer might be purchased at a substantial discount. Nick Bez, president and a major stockholder in the taxpayer, was interested in the acquisition of the two notes by the taxpayer. However, Bez was advised that acquisition by the taxpayer of its own indebtedness at a discount would result in the realization of taxable income in an amount equal to the discount. Bez concluded it would not be feasible for the taxpayer to acquire its two mortgage notes. (I-R. 125.)

On May 21, 1956, Bez and G. Hamilton Beasley, another officer and stockholder in the taxpayer, caused The Ajax Company (hereinafter referred to as "Ajax") to be organized for the purpose of attempt-

ing to purchase the taxpayer's mortgage notes. Bez and Beasley then solicited stockholders of the taxpayer for pro rata contributions and the large majority (85.44 per cent) of taxpayer's stockholders committed themselves to the purchase of Ajax stock and five-year notes, in the total amount of $142,228.52. (I-R. 125.)

Although clear control of the taxpayer was not held by any group or individual, no stockholder influential in the taxpayer, either by virtue of an executive office or because of substantial stock ownership, declined to participate in the formation of Ajax. Bez, personally and through his wholly owned corporation, Trans-Pacific Fishing and Packing, and its related interest in the partnership of Peninsula Packers, controlled the largest single amount of stock in both the taxpayer and Ajax. Beasley was president of Ajax and the largest individual stockholder in the taxpayer. He also was executive vice-president of West Coast Airlines of which Bez was president, and devoted his full time to the airline, the taxpayer and other enterprises in which Bez was interested. (I-R. 125-126.)

On February 21, 1957, the aggregate purchase price paid by Ajax for the taxpayer's mortgage notes was $774,288. The total amount of the taxpayer's indebtedness was then $1,861,514, including accrued interest. The Bank of California loaned Ajax $642,000

and this amount was combined with the $142,228 raised by soliciting stockholders in the taxpayer. Ajax pleged the taxpayer's mortgage notes as security for the loan. (I-R. 126.)

The Seattle First National Bank had previously refused to loan Ajax the additional amount necessary for the purchase of the taxpayer's notes without first receiving the personal guarantee of Bez. The Bank of California agreed to make the loan but conditioned it upon a promise by Bez that a substantial payment on the indebtedness would be made in the near future. On May 17, 1957, the taxpayer paid Ajax $66,737.38 as interest for the year ended March 31, 1957, and thereupon Ajax paid $60,000 to the Bank of California. On May 23, 1957, the taxpayer made a prepayment on the principal of the two mortgage notes to Ajax in the amount of $400,000; on the same day Ajax reduced its indebtedness to the Bank of California by $399,667 ($390,000 principal and $9,667 accrued interest). Thus, by May 23, 1957, and within three months and two days from the time it was incurred, Ajax had reduced its principal indebtedness to the Bank of California from $642,000 to $192,000 by utilizing funds supplied exclusively by the taxpayer and its stockholders. (I-R. 126.)

From the date of its incorporation until it ac-

quired all of the taxpayer's stock on March 25, 1959,[2] Ajax did not engage in any business activity other than to negotiate the purchase of the notes in question. During the same period Ajax had no assets other than the taxpayer's mortgage notes and a small amount of cash. (I-R. 126.)

The primary, dominant and moving purpose for the formation of Ajax was to avoid federal income tax on the purchase of the taxpayer's indebtedness at a discount. (I-R. 127.)

Upon the basis of the foregoing findings the District Court concluded that the notes here involved were in substance purchased by the taxpayer and should be so treated for purposes of determining its tax liability; that the net operating loss deductions claimed by the taxpayer should be disallowed; and that the taxpayer is precluded from recovering the tax refund it seeks in this action "under either or both of Sections 61(a)(12) and 269(a) of the Internal Revenue Code of 1954." (I-R. 122-123, 127.)

---

[2] In 1959, through a series of rather involved transactions, Ajax became the sole stockholder of the taxpayer, the notes in issue were contributed to the taxpayer's capital, and stock of the taxpayer was substituted as collateral for Ajax' remaining indebtedness to the Bank of California, N. A. (See Admitted Facts, I-R. 96-101; Exs. JJ, KK, LL, MM.)

SUMMARY OF ARGUMENT

I

The District Court correctly held that mortgage notes issued by the taxpayer-corporation were in substance (as distinguished from form) purchased by the corporation at a discount, and that the corporation accordingly realized income in the amount of the discount under Section 61(a)(12) of the Internal Revenue Code of 1954 during its 1957 fiscal year (thus absorbing claimed net operating losses which taxpayer seeks to carry forward to its 1960 and 1961 fiscal years). It is true that the notes were purchased by Ajax, another corporation, which was formed by taxpayer's major stockholders for the sole purpose of buying the notes. Ajax was concededly formed to avoid the tax which would result from purchase of the notes by taxpayer. Ajax transacted no business except to purchase the notes during the period in question, and it would have been dissolved if it had not been able to purchase them. Ajax had no choice or discretion as to the purchase of the notes; and the funds and credit required for the purchase were supplied by the taxpayer in major part, the balance of the funds being put up by taxpayer's controlling stockholders. The District Court specifically found that tax avoidance was the primary, dominant and moving purpose for the

formation of Ajax; and, looking through form to substance, the District Court held that the purchase of the notes should be attributed to the taxpayer for the purposes of Section 61(a)(12) of the Code since Ajax was merely a conduit or instrument by means of which taxpayer sought to escape from the impact of that section.

We submit that the District Court made no error. There is virtually no dispute as to the facts, and while taxpayer is correct in asserting that taxpayers have the right to decrease or avoid their taxes by means which the law permits, nevertheless, the fact that a transaction was entered into for tax avoidance purposes and not for any legitimate commercial or industrial purpose is certainly not without significance in determining the applicability of a statute which contemplates a commercial or industrial transaction. Escaping taxation is not a business transaction within the meaning of the revenue laws. If it were, then the long-established rule as to looking through form to substance would be deprived of vitality and the Government would be at the mercy of taxpayers who could effectively employ formalisms devoid of substance in order to escape taxation. In the instant case, Ajax was nothing but a conduit, agent, alter ego, tool, instrumentality or puppet by which taxpayer sought to draw in its notes at a discount without accounting for the income which such a transaction normally gener-

ates. It cannot lightly be presumed that Congress intended to permit the command of the statute (Section 61(a)(12) of the Code) to be disregarded through such a flimsy expedient. Such an attempted disguise should not be allowed to obscure the substance of the transaction in the instant case; and the District Court had ample warrant to hold as it did that the purchase of the notes should be treated for tax purposes as having been made by the taxpayer.

II

The District Court held that Section 269(a) of the 1954 Internal Revenue Code is also applicable in the instant case and constitutes an additional ground for the denial of the taxpayer's claims for refund. We submit that that holding is correct.

Section 269(a) provides that if any person or persons acquire, directly or indirectly, control of a corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of federal income tax by securing the benefit of a deduction, credit, or other allowance which such person would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. The statute further provides that control means at least 50 percent

of the voting power or value of all stock in the acquired corporation.

In the instant case, there is no question as to the existence of the tax avoidance purpose, and it is conceded. There is likewise no question but that stockholders of taxpayer owning over 50 percent of its stock acquired more than 50 percent of the stock of Ajax. It further appears that all of the directors of Ajax were also directors of taxpayer. It follows that the controlling stockholders of taxpayer had direct control of Ajax, and taxpayer itself had indirect control of Ajax for all practical purposes.

It is clear that the acquisition of Ajax was designed to secure the benefit of a deduction, credit or other allowance which the taxpayer and its stockholders would not otherwise enjoy, since the hoped-for tax benefits would include the net operating loss deductions which would be available as carryovers to 1960 and 1961 if not absorbed by income for 1957. The tax attributes of the formation and activity of Ajax directly affect the calculation of taxpayer's income for 1957, and in turn determine whether the carryovers claimed by taxpayer are allowable as deductions in 1960 and 1961. Thus the benefit of the carryovers (if allowable) would accrue to both the taxpayer and its stockholders, and they were persons who stood to pro-

fit taxwise through the organization of Ajax and the purchase by it of the taxpayer's notes. Not only taxpayer, but its stockholders as well, had a definite beneficial interest in obtaining the tax deductions which would flow from the purchase of the notes by Ajax if the form of the transaction were permitted to override its substance and effect. The very purpose of the arrangement was to enable the taxpayer to enjoy an accession to income which would not only be nontaxable but would serve to create a fictitious addition to its net operating losses; if successful, the scheme would avoid any realization of income by taxpayer from the 1957 purchase and would consequently preclude the absorption of the carryovers to 1960 and 1961 which are claimed by the taxpayer as operating loss deductions. Thus taxpayer (and its stockholders) are seeking a tax benefit through the acquisition of Ajax which would not otherwise be enjoyed.

We respectively submit that the District Court's decision is correct in all respects and should therefore be affirmed by this Court.

ARGUMENT

I

THE DISTRICT COURT CORRECTLY HELD THAT TAXPAYER IN SUBSTANCE ACQUIRED ITS OWN INDEBTEDNESS AT A DISCOUNT IN 1957 AND THEREBY REALIZED INCOME IN THE AMOUNT OF THE DISCOUNT UNDER SECTION 61(a)(12) OF THE 1954 INTERNAL REVENUE CODE

There is no question but that the purchase by taxpayer of its two mortgage notes at a discount would constitute taxable income to taxpayer in the amount of the discount. Section 61(a)(12) of the Internal Revenue Code of 1954, Appendix A, *infra; United States* v. *Kirby Lumber Co.*, 284 U.S. 1; 2 Mertens, Law of Federal Income Taxation (1967 Rev.), Section 11.19. The purchase of these two notes by Ajax was in substance a purchase by taxpayer and consequently taxpayer realized taxable income in the ahount of the discount for the fiscal year ended March 31, 1957. The statute of limitations has run on 1957 but a portion of the 1957 income affects the taxable income for the years here involved (fiscal years ended March 31, 1960 and 1961) by eliminating net operating losses which were carried forward to those years by the taxpayer. The disallowance of such net operating loss deductions in the fiscal years ended March 31, 1960 and 1961, is the basis for the deficiencies in

this case. (I-R. 13, 45, 125.) It is undisputed that income for a year closed by the statute of limitations may be adjusted in the determination of the propriety of a net operating loss to be carried forward to an open year. *Vita-Food Corp.* v. *Commissioner*, 238 F. 2d 359 (C.A. 9th); *Phoenix Coal Co.* v. *Commissioner*, 231 F. 2d 420 (C.A. 2d).

It is an established rule that substance must prevail over form in determining the true nature of a transaction for income tax purposes; and that rule has been applied in numerous cases under varying circumstances and statutory provisions. *Eisner* v. *Macomber*, 252 U.S. 189; *United States* v. *Phellis*, 257 U.S. 156; *Commissioner* v. *Court Holding Co.*, 324 U.S. 331; *United States* v. *Lynch*, 192 F. 2d 718 (C.A. 9th), certiorari denied, 343 U.S. 934. Thus, in the *Court Holding Co.* case the Supreme Court said (324 U.S. p. 334):

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be dis-

> guised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

While that case was concerned with determining who was the real seller of property, and the instant case is concerned with determining who was the real purchaser of the notes, the basic principles enunciated above are equally applicable here. See also *Gregory* v. *Helvering*, 293 U.S. 465; *Minnesota Tea Co.* v. *Helvering*, 302 U.S. 609; *Griffiths* v. *Commissioner*, 308 U.S. 355; *Higgins* v. *Smith*, 308 U.S. 473; *Bazley* v. *Commissioner*, 331 U.S. 737; *United States* v. *Cumberland Pub. Serv. Co.*, 338 U.S. 451.

In *United States* v. *Lynch*, *supra*, this Court, in applying the rule as to looking through form to substance, stressed the proposition that in construing tax statutes, which describe commercial or industrial transactions, the statutory words should be deemed to refer to transactions entered upon for commercial or industrial purposes, and not to include transactions entered upon for no other motive but to escape taxation. Of course, this does not mean that no transaction entered into for tax purposes can ever be recognized under the income tax statutes. As was said in *Gregory* v. *Helvering*, *supra*, 293 U.S. p. 469: "The legal right of a taxpayer to decrease the amount of what would otherwise be his taxes, or altogether avoid them, by means

which the law permits, cannot be doubted *** But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." Thus, the fact that a transaction was entered into solely for tax avoidance purposes and not for any legitimate commercial or industrial purpose is certainly not without relevance in determining the applicability of a statute which contemplates a commercial or industrial transaction, since escaping taxation is not such a transaction in the ordinary sense of that term. *National Investors Corp.* v. *Hoey*, 144 F. 2d 466 (C.A. 2d), approved in *National Carbide Corp.* v. *Commissioner*, 336 U.S. 422, 434 (fn. 20). The words of the statute we are dealing with here (Section 61(a)(12) of the 1954 Code) should be given their "plain popular meaning" (*United States* v. *Kirby, supra*, 284 U.S. p. 3); and given that meaning, they obviously contemplate a commercial or industrial transaction. Hence, they require that the purchase of the notes here involved be attributed to the taxpayer even though such purchase was not made directly by the taxpayer but was made by it indirectly through Ajax in the hope of avoiding taxation. In the circumstances it would defeat the Congressional purpose to hold that the impact of the statute could be nullified by an agreement entered upon for no other motive but to escape taxation.

It is true that the District Court in the instant case found that escaping taxation was not the sole motive for the formation of Ajax and its purchase of the taxpayer's notes; but the District Court also found that the alleged business motives (profit incentive and keeping the notes in friendly hands) did not have "any significant or material motivating influence in causing the formation of Ajax and its purchase of the New Harris notes." (I-R. 118.) The District Court has determined in its careful opinion (I-R. 117, 127) that "tax avoidance was the primary, dominant and moving purpose for the formation of Ajax and for its single business activity in purchasing the New Harris indebtedness." The District Court has also found (I-R. 114, 116, 117, 126) that from the date of its incorporation until it acquired all stock of New Harris (taxpayer) on March 25, 1959, Ajax did not engage in any business activity other than to negotiate the purchase of the notes in question; and that during the same period Ajax had no assets other than the notes and a small amount of cash. The District Court further found (I-R. 112, 116, 125) that no stockholder influential in taxpayer, either by virtue of an executive office or because of substantial stock ownership, declined to participate in the formation of Ajax, and that the close relationship of stockholders between taxpayer and Ajax has not been disproven by taxpayer. We submit

that all of these findings by the District Court must be accepted for purposes of the instant review, since it is the duty and prerogative of the trial court to draw inferences and determine what the evidence means (*United States* v. *McNair Realty Co.*, 298 F. 2d 35 (C.A. 9th)), and the findings of the trial court should not be overturned unless clearly erroneous (*United States* v. *Gypsum Co.* 333 U.S. 364, 394-395; *United States* v. *First Security Bank*, 334 F. 2d 120 C.A. 9th)). It cannot seriously be contended that the findings of the District Court were clearly erroneous,[3] and we submit that they fully support the decision for the reasons given above and in the District Court's opinion.

It is true that in *Knetsch v. United States*, 364 U.S. 361, affirming 272 F. 2d 200 (C.A. 9th), the Supreme Court, in holding that certain transactions created no indebtedness which would authorize deductions for amounts paid as interest, did state in its opinion (p. 365) that it would put aside a finding by the trial court that Knetsch's only motive was an attempt to secure an interest deduction. However, the Court went on to hold that what was done in *Knetsch*,

---

[3] Indeed, we do not understand that taxpayer disputes the accuracy of the District Court's findings of fact (Br. 7, 27) except in two minor particulars (Br. 25) which will be discussed later on in this brief.

apart from the tax motive, was not what the statute permitting interest deductions intended, and that in substance and reality Knetsch's transactions were a sham, since they did not appreciably affect his beneficial interest and there was nothing of substance to be realized by Knetsch from the transactions beyond an attempted tax deduction.

We do not interpret the *Knetsch* decision to be at variance with cases such as *Lynch, supra,* where a tax avoidance motive was held to be relevant and material. In *Knetsch* the Court was dealing with a claimed deduction for amounts paid as interest and there was no problem as to whether escaping taxation constitutes a business transaction within the meaning of a statute the words of which describe or presuppose a business transaction. The basic question in *Knetsch* was whether there was a real indebtedness and the Court held there was not: looking through form to substance, the transaction was a sham.

In the instant case Ajax engaged in no business during the period involved except the purchase of taxpayer's notes at a discount, and this was concededly a tax avoidance activity instigated by taxpayer and its stockholders and done by Ajax at their bidding. If Ajax had independent income of its own, it would be entitled to be treated as a separate entity insofar as

its own taxes were concerned (*Paymer* v. *Commissioner*, 150 F. 2d 334 (C.A. 2d)); nevertheless, when we look through form to substance, it seems clear that Ajax was merely an instrument utilized by and in behalf of the taxpayer in order to buy back its notes at a discount. Tax avoidance was the only discernible reason for this subterfuge, and in the circumstances Ajax was nothing but a conduit, agent, alter ego, tool or instrumentality by which taxpayer drew in its notes at a discount. Cf. *Patterson* v. *Commissioner*, decided October 26, 1966 (25 T.C.M. 1230), affirmed *per curiam* May 7, 1968 (C.A. 2d) (68-2 U.S.T.C., par. 9471). It cannot lightly be presumed that Congress intended to allow the taxpayer here to escape taxation by use of a corporate straw man.

Moreover, even if the tax avoidance motive be disregarded in the instant case, the result should be the same. In this connection, attention is invited to *United States* v. *General Geophysical Co.*, 296 F. 2d 86, 88 (C.A. 5th), certiorari denied, 369 U.S. 849, where the court rejected the contention of the taxpayer-corporation that it was entitled to a stepped-up basis for certain property by virtue of a transfer of the property to its major stockholders and an almost immediate repurchase from them by the corporation at an enhanced valuation. In substance and reality, there

never had been a transfer and repurchase in that case. In the instant case, we have a situation where not only was there a dominant tax avoidance motive, but even if that motive were put to one side, still, the things that were done (formation of Ajax and purchase by it of taxpayer's notes at a discount) demonstrate irresistibly that taxpayer in substance purchased the notes through the medium or agency of Ajax. Certainly there is no more reason to treat Ajax as the real purchaser and taxpayer as a stranger in the instant case than there was to treat the taxpayer in *Geophysical* as a real purchaser of assets at a stepped-up basis. Such situations may be compared to the one in the *Knetsch* case, *supra,* where the Supreme Court looked through form to substance and refused to countenance a device for minimizing taxes that however perfect in form would nevertheless defeat the statutory purpose if accepted at face value. And even if Ajax be treated as an independent tax entity for tax purposes generally, still, insofar as concerns the particular transaction here involved, Ajax was nothing but a tool of taxpayer and its stockholders (as we have pointed out above), and it flouts logic and reason to conclude, as taxpayer would have us do, that Congress intended to exempt from the command of Section 61(a)(12) of the Code the income realized from discharge of indebtedness merely because the acquisition of the taxpayer's obli-

gations was effectuated by a straw man set up by the taxpayer.

II

SECTION 269(a) OF THE 1954 INTERNAL REVENUE CODE IS ALSO APPLICABLE

The District Court held (I-R. 118, 123, 127) that Section 269(a) of the 1954 Internal Revenue Code (Appendix A, *infra*) is also applicable in the instant case and constitutes an additional ground for the denial of the taxpayer's claims for refund. We submit that the holding is correct.

Section 269(a) provides that if any person or persons acquire, directly or indirectly, control of a corporation, and the principal purpose for which such acquisition was made is evasion or avoidance of federal income tax by securing the benefit of a deduction, credit, or other allowance which such person would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. The statute further provides that control means at least 50 percent of the voting power or value of all stock in the acquired corporation.

Section 269(a) is substantially the same as its predecessor, Section 129(a) of the Internal Revenue Code of 1939, which was added to that Code by Section 128 of the Revenue Act of 1943, c. 63, 58 Stat. 21. The

Congressional purpose is explained in H. Rep. No. 871, 78th Cong., 1st Sess., p. 49 (1944 Cum. Bull. 901, 938), which reads in part as follows:

> This section adds a new section 129 to Chapter 1 of the Code providing that in the case of acquisitions on or after October 8, 1940, of an interest in or control of corporations or property which the Commissioner finds to be principally motivated by or availed of for the avoidance of income or excess profits tax by securing the benefit of a deduction, credit, or other allowance, then the tax benefits are to be disallowed or allowed only in part in a manner consistent with the prevention of tax avoidance. This section is designed to put an end promptly to any market for, or dealings in, interests in corporations or property which have as their objective the reduction through artifice of the income or excess profits tax liability.
>
> The crux of the devices which have come to the attention of your committee has been some form of acquisition on or after the effective date of the Second Revenue Act of 1940, but the devices take many forms. Thus, the acquisition may be an acquisition of the shares of a corporation, or it may be an acquisition which follows by operation of law in the case of a corporation resulting from a statutory merger or consolidation. The person, or persons, making the acquisition likewise vary, as do the forms or methods of utilization under which tax avoidance is sought. Likewise, the tax benefits sought may be one or more of several deductions or credits, including the utilization of excess profits, credits, carry-overs and carry-backs of losses or unused excess profits credits, and anticipated expense of other deductions. In the light of these considerations, the section has not confined itself to a description of any particular methods for

carrying out such tax avoidance schemes but has included within its scope these devices in whatever form they may appear. For similar reasons, the scope of the terms used in the section is to be found in the objective of the section, namely, to prevent the tax liability from being reduced through the distortion or perversion affected through tax avoidance devices. The term "Federal income or excess profits tax" refers to any Federal tax imposed by Congress upon an income base. The term "deduction, credit or allowance" has reference to any provision which has the effect of diminishing the tax liability resulting from the gross amount of any item of income or the aggregate of the gross amounts of any or all items thereof.

Since the objective of the section is to prevent the distortion through tax avoidance of the deduction, credit, and allowance provisions, the section does not abrogate or delimit, but supplements and extends, the present provisions of the Code, and the principles established by judicial decisions, having the effect of preventing the avoidance of taxes. (See I. R. C., sections 45, 102, 112, 115, and 337; *Gregory* v. *Helvering*, 293 U.S. 465 [Ct. D. 911, C.B. XIV, 193 (1935)]; *Griffiths* v. *Commissioner*, 308 U.S. 355 [Ct. D. 1431, C. B. 1940-1, 136]; *Higgins* v. *Smith*, 308 U.S. 473 [Ct. D. 1434, C.B. 1940-1, 127]; *United States* v. *Joliet & Chicago R. Co.*, 315 U.S. 44 [Ct. D. 1540, C.B. 1942-1, 196]; *Moline Properties* v. *Commissioner*, 319 U.S. 436 [Ct. D. 1584, C. B. 1943, 1011]; *Interstate Transit Lines* v. *Commissioner*, 63 Sup. Ct., 1279 [Ct. D. 1586, C. B. 1943, 1016]; *J. D. & A. B. Spreckles Co.* v. *Commissioner*, 41 B.T.A. 370).

The report of the Senate Committee on Finance (S. Rep. No. 627, 78th Cong., 1st Sess., p. 58 (1944

Cum. Bull. 973, 1016)) contains the following language:

> The objective of the section, as stated in the report on the House bill, is to prevent the distortion through tax avoidance of the deduction, credit, or allowance provisions of the Code, particularly those of the type represented by the recently developed practice of corporations with large excess profits (or the interests controlling such corporations) acquiring corporations with current, past, or prospective losses or deductions, deficits, or current or unused excess profits credits, for the purpose of reducing income and excess profits taxes. The House report also recognizes that the legal effect of the section is, in large, to codify and emphasize the general principle set forth in *Higgins* v. *Smith* (308 U.S. 473 [Ct. D. 1434, C. B. 1940-1, 127]), and in other judicial decisions, as to the ineffectiveness of arrangements distorting or perverting deductions, credits, or allowances so that they no longer bear a reasonable business relationship to the interests or enterprises which produced them and for the benefit of which they were provided.

See also Treasury Regulations on Income Tax (1954 Code), Sections 1.269-1, 1.269-2 and 1.269-3, Appendix A., *infra.*

It is readily apparent that Section 269 of the Code, like its predecessor (Section 129 of the 1939 Code), is broad in scope and specifically prohibits the allowance of tax benefits from acquisitions made principally for tax avoidance purposes. Many cases have been de-

cided under these statutes, some of which are as follows: *American Pipe & Steel Corp.* v. *Commissioner*, 243 F. 2d 125 (C.A. 9th); *Commissioner* v. *British Motor Car Distributors, Ltd.*, 278 F. 2d 392 (C.A. 9th); *Bonneville Locks Towing Co.* v. *United States*, 343 F. 2d 790 (C.A. 9th); *J. T. Slocomb Co.* v. *Commissioner*, 334 F. 2d 269 (C.A. 2d); *Luke* v. *Commissioner*, 351 F. 2d 568 (C.A. 7th); *R. P. Collins & Co.* v. *United States*, 303 F. 2d 142 (C.A. 1st).

As noted by the District Court herein (I-R. 121), the requirement as to "principal purpose" means that the tax avoidance purpose must exceed in importance any other purpose. See *Hawaiian Trust Co.* v. *United States*, 291 F. 2d 761 (C.A. 9th). This is a question of fact (*Bonneville Locks Towing Co.* v. *United States*, *supra; J. T. Slocomb Co.* v. *Commissioner*, *supra*); and as pointed out in the previous section of this brief, the District Court specifically found that the stockholders of taxpayer who created Ajax had the primary purpose of tax avoidance which far exceeded in significance any other motivation. (I-R. 118, 122.) Moreover, this tax avoidance motive has been conceded by taxpayer and is not denied. (Br. 26, 28.)

However, in order to justify the application of Section 269 in the instant case, it must also appear that the control of Ajax was acquired by a person or

persons in order to secure the benefit of a deduction, credit, or other allowance which such person or persons would not otherwise enjoy. In this connection the District Court found (I-R. 112) that no stockholder influential in taxpayer either by virtue of an executive office or because of substantial stock ownership, declined to participate in the formation of Ajax and that the large majority of stockholders of taxpayer (85.44%) committed themselves to the purchase of Ajax stock. While taxpayer apparently disputes this 85.44 figure (Br. 25), and attention will be given to that aspect of the case in the next section of this brief, nevertheless, we understand it to be undisputed that the effective and controlling stockholders in both corporations (taxpayer and Ajax) were identical; and we further understand it to be undisputed that such stockholders held over 50 percent of the stock of both companies (I-R. 120; Br. 4, 7, 10). It accordingly appears that stockholders of taxpayer owning over 50 percent of its stock acquired more than 50 percent of the stock of Ajax; and this would constitute direct control of Ajax by such stockholders and indirect control of Ajax by the taxpayer.[4] Cf. *Southland Corp.* v. *Campbell*, 358 F. 2d 333 (C.A. 5th).

It seems clear that the acquisition of Ajax was

[4] It further appears that all of the directors of Ajax were also directors of taxpayer. See Exs. W, BB.

designed to secure the benefit of a deduction, credit or other allowance which the taxpayer and its stockholders would not otherwise enjoy, since, as succinctly pointed out by the District Court (I-R. 120-121), the hoped-for tax benefits were the net operating loss deductions which would not be available as carryovers from 1957 if absorbed by income for that year. As stated by the District Court (I-R. 121):

> Obviously, New Harris [taxpayer] itself must suffer losses without regard to Ajax before the carryover provisions apply. The amount of the carryover available to New Harris in a given year will be directly affected by the amount of income attributed to New Harris in earlier years, including the taxable year ended March 31, 1957 with which this case is concerned. The tax attributes of the formation and activity of Ajax directly affect these calculations of New Harris income for the period in question, and in turn determine the amount of carryover which New Harris is entitled to claim.

Thus the benefit of the carryovers (if allowable) would accrue directly to the taxpayer and indirectly to its stockholders, the majority of which concededly participated in the plan. There is no question but that the purchase by taxpayer of its obligations at a discount would result in income to taxpayer sufficient to absorb the claimed operating loss carryovers (*United States* v. *Kirby Lumber Co., supra*); and taxpayer does not contend otherwise.

The situation in the instant case is quite similar to the one in *Commissioner* v. *British Motor Car Distributors, Ltd., supra,* where this Court said (278 F. 2d, p. 395):

> The corporation contends, as stated by the Tax Court, that the benefit to the stockholders (as distinguished from that to the corporate taxpayer) is too tenuous to bring the section into play. Tenuous or not, it is the benefit which actuated these persons in acquiring this corporation and is thus the very benefit with which this section is concerned. It is not for the courts to judge whether the benefit to the acquiring persons is sufficiently direct or substantial to be worth acquiring. That judgment was made by the acquirers. The judicial problem is whether the securing of the benefit was the principal purpose of the acquisition. If it was, the allowance of the deduction is forbidden.***

See also *Bush Hog Manufacturing Co.* v. *Commissioner*, 42 T.C. 713, 729, Acquiescence, 1964-2 Cum. Bull. 4; Treasury Regulations on Income Tax (1954 Code), Section 1.269-3.

In the circumstances, we submit that the District Court made no error in holding as it did that Section 269(a) of the Code, as well as Section 61(a) (12), requires the denial of the tax refund sought by the taxpayer in this action.

III

THE TAXPAYER'S CRITICISMS OF THE DISTRICT COURT'S DECISION ARE NOT WELL GROUNDED.

A. *As to the Section 61(a)(12) issue*

The taxpayer says (Br. 30) that the District Court did not explain how its determination as to tax avoidance would result in the attribution to taxpayer of the purchase of the notes. However, the explanation may be found in the District Court's opinion which reads in part as follows (I-R. 117):

> Under all the facts and circumstances shown by the evidence, the court finds and holds that tax avoidance was the primary, dominant and moving purpose for the formation of Ajax and for its single business activity in purchasing the New Harris indebtedness. Without the purpose of tax avoidance, formation of Ajax would not have occurred. Ajax was formed essentially for the purpose of doing for New Harris that which New Harris itself, due to income tax considerations, decided not to do, namely, acquire the New Harris mortgage notes at a discount.

See also I-R. 127, where the District Court concluded as a matter of law that:

> 1. The New Harris notes were in substance purchased by New Harris and should be so treated for purposes of determining the federal income tax liability. Accordingly, New Harris realized taxable income under Section 61(a)(12) of the

> Internal Revenue Code of 1954 upon the purchase of the New Harris notes at a discount.

Thus, the District Court has in effect found and concluded that Ajax acted merely as a conduit for the purchase of the two notes by the taxpayer (New Harris), and therefore such purchase should be treated for tax purposes as having been made by the taxpayer. This is in accordance with cases such as *Gregory* v. *Helvering, supra,* and *Minnesota Tea Co.* v. *Helvering, supra.* In the *Minnesota Tea* case the Court said (302 U.S., pp. 613-614):

> A given result at the end of a straight path is not made a different result because reached by following a devious path. The preliminary distribution to the stockholders was a meaningless and unnecessary incident in the transmission of the fund to the creditors, all along intended to come to their hands, so transparently artificial that further discussion would be a needless waste of time. The relation of the stockholders to the matter was that of a mere conduit.***

See also *Commissioner* v. *Court Holding Co., supra,* where the Court said (324 U.S., p. 334) that a sale by one person cannot be transformed into a sale by another by using the latter as a conduit through which to pass title. This principle was recently applied by the Fifth Circuit in an analogous case (*Davant* v. *Commissioner*, 366 F. 2d 874, certiorari denied, 386 U.S. 1022), where the court looked through form to sub-

stance in treating an alleged sale to one Bruce as a mere paper subterfuge and holding that he was a mere conduit by means of which the taxpayers hoped to disguise the true nature of the transaction for tax purposes. In this connection the Fifth Circuit said (366 F. 2d, p. 881):

> ***to allow the "sale" to Bruce, Jr. to divert our attention from the tax policies enacted by Congress would be to exalt form above all other criteria. He served no function other than to divert our attention and avoid tax. Stated another way, his presence served no legitimate nontax-avoidance business purpose. Cf. *Commissioner of Internal Revenue* v. *Court Holding Co.*, 324 U.S. 331, 65 S.Ct. 707 (1945); *Campbell* v. *Wheeler*, 342 F. 2d 837 (5 Cir. 1965); *United States* v. *Lynch*, 192 F. 2d 718 (9 Cir. 1951), cert. den., 343 U.S. 934, 72 S.Ct. 770, 96 L.Ed. 1342 (1952);***

And see *Factor* v. *Commissioner*, 281 F. 2d 100, 110-113 (C.A. 9th), certiorari denied, 364 U.S. 933; *Babcock* v. *Phillips*, 372 F. 2d 240 (C.A. 10th), certiorari denied, 387 U.S. 918.

The taxpayer relies heavily (Br. 31-34) on *Chisholm* v. *Commissioner*, 79 F. 2d 14 (C.A. 2d), but we do not read that case as being contrary to the decision of the District Court in the instant one. *Chisholm* merely held that the taxpayers formed a real, enduring partnership which acted for itself and not as a conduit or agent for the taxpayers individually in

making the sale of the transferred stock. Thus, the transaction in *Chisholm* was considered as having economic substance, and the tax avoidance motive for formation of the partnership did not operate to change the result. In the instant case the major portion of the funds used to purchase the two mortgage notes was provided by taxpayer and the remainder of the purchase price was furnished by its principal stockholders. (I-R. 126.) Everybody concerned apparently thought that the two notes were extinguished upon their purchase by Ajax, and in 1959 the notes were in fact turned over to taxpayer by Ajax as a contribution to capital. (I-R. 100-101; Exs. LL, MM.) The conceded reason for this round-about process was tax avoidance, and looking through form to substance it is plain that the District Court had warrant to treat Ajax as a mere conduit or tool of the taxpayer. We take it that nobody contends that Ajax had any choice in the matter or that it would or could have refused to purchase the notes. Thus, Ajax was a mere puppet of taxpayer in making the purchase. Cf. *National Lead Co.* v. *Commissioner*, 336 F. 2d 134, 140-141 (C.A. 2d), certiorari denied, 380 U.S. 908.

Cases such as Sun Properties v. United States, 220 F. 2d 171 (C.A. 5th), cited by taxpayer (Br. 35-38), do not advance its cause here, and, indeed, it will

be noted that the court in *Sun Properties* stated that transactions are subject to careful scrutiny when the only ascertainable motive is tax avoidance. In the instant case the District Court carefully scrutinized the transactions and concluded that they were in substance a purchase by taxpayer. See also *Goldstein* v. *Commissioner*, 298 F. 2d 562, 568 (C.A. 9th); and cf. *United States* v. *Ramos*, 393 F. 2d 618 (C.A. 9th).

In *Twin Oaks Co.* v. *Commissioner*, 183 F. 2d 385 (C.A. 9th), cited by taxpayer (Br. 38-39), the court held that the change in business structure from corporation to partnership had sufficient reality and substance to preclude taxing all of the income of the business to the corporation. We do not read that decision as having any material bearing on the instant case. Here the taxpayer and its stockholders had complete domination and control over Ajax and Ajax would concededly have been dissolved if it had been unable to purchase the notes for taxpayer. (II-R. 99.)[5]

---

[5] Thus Mr. Bez testified (II-R. 99):

Q. Mr. Bez, if you are not able to acquire those two mortgage notes due to some unforeseen difficulty, would the stock of Ajax have been issued anyway on February 21, 1957, if you hadn't been able to acquire the two mortgage notes?

A. If we wasn't able, no.

Q. Can you tell me why the Ajax stock would not have been issued in that eventuality?

Footnote continued on page 35

The taxpayer says (Br. 40-42) that purchase of mortgage notes at a discount from unrelated third parties is a legitimate business activity which does not lose its quality as such merely because motivated by tax avoidance. However, that assertion is too broad and in effect begs the question which is whether the taxpayer in substance purchased the notes through Ajax. The actual purchase was indeed a business transaction, but the only reason Ajax was brought into the picture at all was to divert attention and avoid tax. See *Davant* v. *Commissioner, supra.* Thus, the business end of the transaction must be attributed to taxpayer as the District Court held.

Cases such as *Koppers Co.* v. *Commissioner*, 2 T.C. 152, Acquiescence, 1943 Cum. Bull. 14, relied upon by taxpayer (Br. 43-48), do not support its views. The facts are not comparable to the facts of the instant case. In *Koppers*, the parent company purchased bonds theretofore issued by its subsidiary which the latter had neither the funds nor the credit to buy.

A. Well, we had the money, and if he wasn't able to buy those notes, we would have returned the money to the original fellows that put up the $142,000.00 and dissolved the company, and that would be it.

THE COURT: Dissolve Ajax?

THE WITNESS: Dissolve Ajax, that is the only thing we could do if we weren't able to buy those notes.

Here, the taxpayer had the means to purchase its obligations and actually financed the transaction. Ajax was the mere puppet of taxpayer, as we have pointed out above. See also I-R. 116, where the District Court commented on *Koppers*.

The taxpayer says (Br. 48-54) that all taxpayers have a clear right to employ any legitimate method of conducting their affairs to avoid incurring a tax liability which might have resulted had a different method been adopted. Nobody disputes that as a general proposition, and the District Court recognized its validity. (I-R. 115.) But it does not follow that it is applicable here. It seems clear that an arrangement which served no legitimate nontax-avoidance business purpose does not have to be accepted at face value, for tax purposes, and that substance must control over form in a case of this character. *Davant* v. *Commissioner*, *supra*. We submit that the District Court did not err in so holding in the instant case. Cases such as *Kobacker* v. *Commissioner*, 37 T.C. 882, Acquiescence, 1964-2 Cum. Bull. 6; and *Chase* v. *Commissioner*, decided July 23, 1965 (24 T.C.M. 1054), cited by taxpayer (Br. 48-54), turn on their peculiar facts, and we do not read those decisions as having any material bearing on the instant case. Here, Ajax was formed to buy the taxpayer's notes and actually did so with funds and credit supplied in major part by the

taxpayer. Ajax had no choice and had to do what it was formed and established for the sole purpose of doing, as we have pointed out above. In the circumstances, Ajax was nothing but a conduit, agent, alter ego, tool or instrumentality by which taxpayer drew in the notes at a discount, as we have also noted above. It makes no difference what we call Ajax in this connection, for the "label counts for little." *Stearns Co.* v. *United States*, 291 U.S. 54, 61. For the purposes of the instant transaction, Ajax was completely controlled by taxpayer and its stockholders and Ajax had no independence at all.

The taxpayer contends (Br. 54-55) that if the corporate entity of Ajax were to be disregarded, its corporate activities would be attributable only to its stockholders, not to the taxpayer. But the activity that concerns us here, purchase of taxpayer's obligations at a discount, was designed and intended by all concerned to be for the primary tax benefit of the taxpayer, and taxpayer's stockholders had that end in view when Ajax was organized. *Commissioner* v. *Montgomery*, 144 F. 2d 313 (C.A. 5th), referred to by the taxpayer (Br. 54-55), is not in point, and it does not support the taxpayer's position here.

B. *As to the Section 269(a) issue*

The taxpayer, citing the decision of this Court in

Commissioner v. *British Car Distributors, Ltd., supra,* but ignoring its true rationale, states (Br. 56-57) that although the stockholders controlling the taxpayer did acquire control of Ajax (for tax avoidance purposes), still, the only deduction involved is the operating loss claimed by taxpayer, and Section 269(a) is inapplicable because taxpayer did not acquire control of Ajax, nor did Ajax acquire control of taxpayer. We submit that the argument is without merit. In the first place, taxpayer did acquire indirect control of Ajax since taxpayer's controlling stockholders concededly also controlled Ajax, and the directors of Ajax were also directors of taxpayer, as pointed out in the previous section of this brief. The use of the words "directly or indirectly" in the statute should be read in the light of its manifest purpose to put an end to all devices in whatever form they may appear, whereby control of a corporation is acquired for the purpose of obtaining tax bene fits (including carryovers and carrybacks of losses) which would not otherwise be enjoyed. See H. Rep. No. 871, *supra.* It would be incompatible with such sweeping objectives to hold, as taxpayer would have us do, that taxpayer did not acquire indirect control of Ajax in the circumstances of the instant case.[6]

---

[6] *Brick Milling Co.* v. *Commissioner,* decided November 13, 1963 (22 T.C.M. 1603); and *Thomas E. Snyder Sons Co.* v. *Commissioner,* 288 F. 2d 36 (C.A. 7th), certiorari denied, 368 U.S. 823, referred to by the taxpayer (Br. 58-59), are distinguishable on the facts.

Moreover, even if taxpayer were right in this respect (which we deny), it would not change the result since its controlling stockholders indisputably acquired direct control of Ajax within the purview of the statute, and they were persons having sufficient interest in the claimed deductions to bring the statute into operation. The taxpayer admits (Br. 57) that the stockholders controlling taxpayer did acquire control of Ajax in the course of the transactions here involved, but takes the position that no deduction, credit, or other allowance claimed by Ajax or such stockholders is challenged. However, the taxpayer is wrong, for the acquirers were plainly actuated by the benefits to taxpayer which they hoped to achieve, and although the acquiring stockholders were not claiming the deductions in their individual returns, nevertheless, they, as stockholders, certainly had a beneficial interest in the deductions of the taxpayer. See *Commissioner* v. *British Motor Car Distributors, Ltd.*, *supra.*

The taxpayer relies heavily (Br. 59-61) on *Maxwell Hardware Co.* v. *Commissioner*, 343 F. 2d 713 (C.A. 9th), but that case was not ignored by the District Court (I-R. 119) and it is not at variance with our position here. In that case the acquirers did not have the required 50 percent control; in the instant case there is no question but that they did.

The taxpayer presents a strained argument (Br. 61-66) designed to show that it did not secure any tax benefit from the purchase of the notes by Ajax. But that argument is essentially fallacious, for, as pointed out above and in the opinion of the District Court herein, the very purpose of the transaction was to enable the taxpayer to avoid the amount of 1957 income entailed in the purchase of its notes at a discount; and of course such avoidance, if successful, would preclude the absorption of the carryovers to 1960 and 1961 which are claimed by the taxpayer as operating loss deductions. Thus taxpayer (and its stockholders) are seeking a tax benefit through the acquisition of Ajax which would not otherwise be enjoyed.

Taxpayer's reliance (Br. 63-66) on *Nutt* v. *Commissioner*, 39, T.C. 231, affirmed on another point, 351 F. 2d 452 (C.A. 9th), certiorari denied, 384 U.S. 918; and *Cromwell Corp.* v. *Commissioner*, 43 T.C. 313, Acquiescence, 1965-2 Cum. Bull. 4, is misplaced. In the *Nutt* case, the Internal Revenue Service determined that two newly-organized corporations were shams so that their net income should be taxed to the individuals who organized them. The Tax Court in overruling the Service held that the corporations were real business entities, taxable as such, and that Section 269 was inapplicable since the Service had not disallowed to the individual taxpayers any deductions

laimed by them, but, rather, increased both the in-
ome and deductions claimed by them on their returns.
n the instant case, the tax authorities and the Dis-
rict Court have disallowed the carry-forwards claimed
y taxpayer and those are the deductions which would
e enjoyed only if the transparent tax avoidance plan
ere involved were upheld. The *Cromwell* case is also
istinguishable on the facts and it is of no assistance
o the taxpayer here.

In the light of the foregoing considerations, we
ubmit that the decision of the District Court is in all
espects correct.[7]

We are not unmindful of taxpayer's specifications of errors numbers
and 5 (Br. 25). Taxpayer says in specification 4 that the trial court
rred in finding that 85.44 percent of taxpayer's stockholders com-
itted themselves to purchase Ajax stock and notes; and in specifica-
on 5 that the trial court erred in finding that taxpayer paid Ajax
66,737 on May 17, 1957, since such payment was in fact made on
pril 2, 1957.

As to the 85.44 figure, this is based on a tabulation attached to
his brief as Appendix B which shows that on February 21, 1957 (date
f purchase of taxpayer's notes by Ajax), Ajax shareholders held
5.44 percent of taxpayer's stock (12,816 shares out of 15,000 shares
utstanding). This computation was presented to and accepted by
he District Court. It was based upon a determination by the Gov-
rnment that the majority of the stockholders of taxpayer (New Har-
is) and Ajax fell into one of three groups of investors; that such
roups would follow their leader and that the registration of the
tock was not always indicative of the real beneficial ownership. See
Nutt v. *Commissioner, supra,* 351 F. 2d, p. 454; *Commissioner* v.
catena, 85 F. 2d 729, 732 (C.A. 9th); *Bonsall* v. *Commissioner,* 317
. 2d 61, 63 (C.A. 2d). However, it does not appear that the exact
Footnote continued on page 42

CONCLUSION

The judgment of the court below should be affirmed.

Respectfully submitted,

MITCHELL ROGOVIN,
Assistant Attorney General.

LEE A. JACKSON,
MEYER ROTHWACKS,
LORING W. POST,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

Of Counsel:

EUGENE G. CUSHING,
United States Attorney.

CHARLES W. BILLINGHURST,
Assistant United States Attorney.

SEPTEMBER, 1968.

---

figure is important in the instant case, since it is undisputed that th[e] larger number of the stockholders of taxpayer subscribed for Aja[x] stock and notes (Br. 4, 7, 26, 27) and that no stockholder influentia[l] in taxpayer, either by virtue of an executive office or because o[f] substantial stock ownership, declined to participate in the formatio[n] of Ajax (Br. 10). Moreover, the point does not seem to be an ap[-] propriate one for consideration by this Court; and if the taxpaye[r] desires to contest the District Court's findings, taxpayer should a[t] least show why the finding is wrong and also what is the correc[t] figure, since the taxpayer has the burden of proof. *Helvering* v[.] *Taylor,* 293 U.S. 507, 514.

As to the taxpayer's specification of error number 5, it doe[s] appear that the date should be April 2, 1957, as asserted by tax[-] payer (Br. 25), rather than May 17, 1957, as found by the Distric[t] Court (I-R. 126); but in any event the error appears to be immateria[l] and taxpayer does not contend that it is material.

CERTIFICATE OF SERVICE

It is hereby certified that service of this brief has ɩeen made on opposing counsel, by mailing four copies hereof on this ...... day of ...., 1968, n an envelope, with postage prepaid, properly ad-ɩressed to them as follows:

Graham, Dunn, Johnston & Rosenquist
Bryant R. Dunn
James W. Johnston
William R. Smith
625 White-Henry-Stuart Building
Seattle, Washington 98104

____
Assistant United States Attorney

APPENDIX A

Internal Revenue Code of 1954:

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.* — Except as other wise provided in this subtitle, gross income mean all income from whatever source derived, includ ing (but not limited to) the following items:

* * * * *

(12) Income from discharge of indeb tedness;

* * * * *

(26 U.S.C. 1964 ed., Sec. 61.)

SEC. 269. ACQUISITIONS MADE TO EVAD OR AVOID INCOME TAX.

(a) *In General.* — If —

(1) any person or persons acquire, o acquired on or after October 8, 1940, directl or indirectly, control of a corporation, or

(2) any corporation acquires, or ac quired on or after October 8, 1940, directl or indirectly, property of another corpora tion, not controlled, directly or indirectly, im mediately before such acquisition, by suc acquiring corporation or its stockholders, th basis of which property, in the hands of th acquiring corporation, is determined by re ference to the basis in the hands of the trans feror corporation,

and the principal purpose for which such acquisi

tion mas made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then such deduction, credit, or other allowance shall not be allowed. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation.

* * * * *

(26 U.S.C. 1964 ed., Sec. 269.)

'reasury Regulations on Income Tax (1954 Code):

Sec. 1.61-12 *Income for discharge of indebtedness*

(a) *In general.* The discharge of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, the debtor realizes income in the amount of the debt as compensation for his services. A taxpayer may realize income by the payment or purchase of his obligations at less than their face value.***

* * * * *

(c) *Sale and purchase by corporation of its bonds.* (1) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. If the corporation purchases any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. If, how-

ever, the corporation purchases any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is income for the taxable year.

* * * * *

(5) For purposes of this paragraph, a debenture, note, or certificate or other evidence of indebtedness, issued by a corporation and bearing interest shall be given the same treatment as a bond.

* * * * *

(26 C.F.R., Sec. 1,61-12.)

Sec. 1.269-1 [as added by T.D. 6595, 1962-1 Cum. Bull. 43] *Meaning and use of terms.****

(a) *Allowance.* The term "allowance" refer to anything in the internal revenue laws which has the effect of diminishing tax liability. The term includes, among things, a deduction, a credit, an adjustment, an exemption, or an exclusion.

(b) *Evasion or avoidance.* The phrase "evasion or avoidance" is not limited to cases involving criminal penalties, or civil penalties for fraud.

(c) *Control.* The term "control" means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock of the corporation. For control to be "acquired on or after October 8, 1940", it is not necessary that all of such stock be acquired on or after October 8, 1940. Thus, if A, on October 7, 1940, and at all times thereafter, owns 40 percent of the stock of

X Corporation and acquires on October 8, 1940, an additional 10 percent of such stock, an acquisition within the meaning of such phrase is made by A on October 8, 1940. Similarly, if B, on October 7, 1940, owns certain assets and transfers on October 8, 1940, such assets to a newly organized Y Corporation in exchange for all the stock of Y Corporation, an acquisition within the meaning of such phrase is made by B on October 8, 1940. If, under the facts stated in the preceding sentence, B is a corporation, all of whose stock is owned by Z Corporation, then an acquisition within the meaning of such phrase is also made by Z Corporation on October 8, 1940, as well as by the shareholders of Z Corporation taken as a group on such date, and by any of such shareholders if such shareholders as a group own 50 percent of the stock of Z on such date.

(d) *Person.* The term "person" includes an individual, a trust, an estate, a partnership, an association, a comnany, or a corporation.

(26 C.F.R., Sec. 1.269-1.)

Sec. 1.269-2 [as added by T.D. 6595, *supra*] *Purpose and scope of section 269.*

(a) *General.* Section 269 is designed to prevent in the instances specified therein the use of the sections of the Internal Revenue Code providing deductions, credits, or allowances in evading or avoiding Federal income tax. See § 1.269-3.

(b) *Disallowance of deduction, credit, or other allowance.* Under the Code, an amount otherwise constituting a deduction, credit, or other allowance becomes unavailable as such under certain circumstances. Characteristic of such circumstances are those in which the effect

of the deduction, credit, or other allowance would be to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate. The distortion may be evidenced, for example, by the fact that the transaction was not undertaken for reasons germane to the conduct of the business of the taxpayer, by the unreal nature of the transaction such as its sham character or by the unreal or unreasonable relation which the deduction, credit, or other allowance bears to the transaction. The principle of law making an amount unavailable as a deduction, credit, or other allowance in cases in which the effect of making an amount so available would be to distort the liability of the taxpayer, has been judicially recognized and applied in several cases. Included in these cases are *Gregory* v. *Helvering* (1935) (293 U.S. 465; Ct. D. 911, C.B. XIV-1, 193); *Griffiths* v. *Helvering* (1939) (308 U.S. 355; Ct. D. 1431, C.B. 1940-1, 136); *Higgins* v. *Smith* (1940) (308 U.S. 473; Ct. D. 1434, C.B. 1940-1, 127) and *J. D. & A. B. Spreckles Co.* v. Commissioner (1940) (41 B.T.A. 379). In order to give effect to such principle, but not in limitation thereof, several provisions of the Code, for example, section 267 and section 270, specify with some particularity instances in which disallowance of the deduction, credit, or other allowance is required. Section 269 is also included in such provisions of the Code. The principle of law and the particular sections of the Code are not mutually exclusive and in appropriate circumstances they may operate together or they may operate separately. See, for example, § 1.269-6.
(26 C.F.R., Sec. 1.269-2.)

Sec. 1.269-3 [as added by T.D. 6595, *supra*]

Instances in which section 269(a) disallows a deduction, credit, or other allowance. (a) Instances of disallowance. Section 269 specifies two instances in which a deduction, credit, or other allowance is to be disallowed. These instances, described in paragraphs (1) and (2) of section 269(a), are those in which—

(1) Any person or persons acquire, or acquired on or after October 8, 1940, directly, or indirectly, control of a corporation, or

(2) Any corporation acquires, or acquired on or after October 8, 1940, directly or indirectly, property of another corporation (not controlled, directly or indirectly, immediately before such acquisition by such acquiring corporation or its stockholders), the basis of which property in the hands of the acquiring corporation is determined by reference to the basis in the hands of the transferor corporation.

In either instance the principal purpose for which the acquisition was made must have been the evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such other person, or persons, or corporation, would not otherwise enjoy. If this requirement is satisfied, it is immaterial by what method or by what conjunction of events the benefit was sought. Thus, an acquiring person or corporation can secure the benefit of a deduction, credit, or other allowance within the meaning of section 269 even though it is the acquired corporation that is entitled to such deduction, credit, or other allowance in the determination of its tax. If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose. This does not mean that only those acquisitions

fall within the provisions of section 269 whic would not have been made if the evasion or avoic ance purpose was not present. The determinatio of the purpose for which an acquisition was mad requires a scrutiny of the entire circumstance in which the transaction or course of conduct oc curred, in connection with the tax result claime to arise therefrom. For the presumption of a prir cipal purpose of tax evasion or avoidance, se section 269(c) and § 1.269-5.

(b) *Acquisition of control; transactions in dicative of purpose to evade or avoid tax.* If th requisite acquisition of control within th meaning of paragraph (1) of section 269(a) ex ists, the transactions set forth in the followin subparagraphs are among those which, in th absence of additional evidence to the contrary ordinarily are indicative that the principal pur pose for acquiring control was evasion or avoic ance of Federal income tax:

(1) A corporation or other business enter prise (or the interest controlling such corporatio or enterprise) with large profits acquires contro of a corporation with current, past, or prospectiv credits, deductions, net operating losses, or othe allowances and the acquisition is followed by suc transfers or other action as is necessary to brin the deduction, credit, or other allowance into cor junction with the income (see further § 1.269-6) This subparagraph may be illustrated by the fo lowing example:

Example. Individual A acquires all of th stock of L Corporation which has been engage in the business of operating retail drug store: At the time of the acquisition, L Corporation ha net operating loss carryovers aggregating $100 000 and its net worth is $100,000. After the ac

quisition, L Corporation continues to engage in the business of operating retail drug stores but the profits attributable to such business after the acquisition are not sufficient to absorb any substantial portion of the net operating loss carryovers. Shortly after the acquisition, individual A causes to be transferred to L Corporation the assets of a hardware business previously controlled by A which business produces profits sufficient to absorb a substantial portion of L Corporation's net operating loss carryovers. The transfer of the profitable business, which has the effect of using net operating loss carryovers to offset gains of a business unrelated to that which produced the losses, indicates that the principal purpose for which the acquisition of control was made is evasion or avoidance of Federal income tax.

(2) A person or persons organize two or more corporations instead of a single corporation in order to secure the benefit of multiple surtax exemptions (see section 11(c)) or multiple minimum accumulated earnings credits (see section 535(c) (2) and (3)).

(3) A person or persons with high earning assets transfer them to a newly organized controlled corporation retaining assets producing net operating losses which are utilized in an attempt to secure refunds.

* * * * *

(26 C.F.R., Sec. 1.269-3.)

APPENDIX B

AJAX SHAREHOLDERS HELD 85.44% OF NE[illegible] HARRIS STOCK ON FEBRUARY 21, 1957

	Shares of New Harris	Shares [illegible] Ajax
Nick Bez	1,061.60	1,150
Peninsula Packers	2,735*	2,735
Trans-Pacific Fishing & Packing	352	352
Bergues Group		
Geneva Corporation	1,765	1,765
Ivan L. Best	441	441
Edward Heller	442	442
Wilbur-Ellis Group		
Brayton Wilbur	797	177
William A. Hinckley		44
H. A. Magnuson		89
R. B. Mattson		89
Ned Lewis		177

aats Group		
Hamilton Beasley	2,856	618
Donald Royce	161	
Staats & Co.		1,393
Fred Tuerk and relatives		1,957
J. E. Jardine (deceased)	608	
J. E. Jardine, Jr.	44	
W. L. Berger	18	
Mrs. R. M. Sturdevant	36	
Robert S. Burns	441	441
Finn Lepsoe	352	352
Thomas J. Bannon (Webster-Brinckley Co.)	706.40	706
Total	12,816	12,928
ercent of Total Shares Outstanding	85.44%	100%

1,764 shares were held jointly by Trans-Pacific Fish-
ıg & Packing and the Calvert Corporation who were
ıe predecessors of Peninsula Packers.